No. 461

In the Supreme Court of the United States

OCTOBER TERM, 1950

STACY C. MOSSER, SUCCESSOR TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, AND JOHN W. GUILD, INDENTURE TRUSTEE, ETC., PETITIONERS

v.

PAUL E. DARROW, FORMER TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR SECURITIES AND EXCHANGE COMMISSION

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OPINIONS BELOW

The opinion of the Court of Appeals (R. 675–691) is reported in 184 F. 2d 1. The memorandum opinion of the District Court (R. 577–585) is not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 14, 1950 (R. 692). A petition for rehearing was denied by the Court of

Appeals on September 21, 1950 (R. 727). The petition for a writ of certiorari was granted on February 26, 1951. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED

1. Where a reorganization trustee files a petition for a writ of certiorari in the name of his predecessor, who was the party of record in the court below, may this Court permit substitution and review the decision below on the merits?

2. Whether a reorganization trustee was properly surcharged for profits realized, with his knowledge and assistance, by his subordinates from trading in securities of the debtors' subsidiaries, particularly where the trustee was himself engaged in purchasing the same securities for the benefit of the estate and purchased some of them from these employees at a profit to them.

STATEMENT

The reorganization proceedings here involved were begun under former Section 77B of the Bankruptcy Act (48 Stat. 911) and subsequently made subject to various provisions of Chapter X, at which time the Commission became a statutory party pursuant to Section 208 (11 U. S. C. 608). The Commission supported the petition herein, and, although technically a statutory respondent, submits this brief in support of the petitioners. The petitioners are the successor reorganization

trustees and the indenture trustee for the collateral trust bonds of one of the debtors.

The debtors, Federal Facilities Realty Trust ("Federal") and National Realty Trust ("National"), are common law trusts (R. 577) which were organized by Jacob Kulp and Myrtle Johnson in 1929 and 1930, respectively, as real estate holding companies to control and to operate 27 companies, each of which owned a parcel of real estate with a building thereon. Although Kulp retained large blocks of securities, substantial amounts of the securities of both debtors are publicly held.[1]

The subsidiary companies had been promoted principally by Kulp and Myrtle Johnson (R. 578–579). Land acquisitions and the construction of the buildings had been financed through the public sale of bonds of these companies, while the capital stock was retained by Kulp and members of his family. Subsequently, when the value of the real estate properties declined and the maturities of several bond issues were imminent, the debtors were organized to acquire the equity in

[1] The capital structure of Federal consists of $558,300 in principal amount of collateral trust bonds, of which $84,000 have been reacquired by Federal, and 100,000 units of beneficial interest. Of these securities, $188,200 in principal amount of bonds and 37,642 units of beneficial interest are publicly held. National has no funded debt. Its outstanding securities consist solely of 46,636.1 units of beneficial interest, of which 25,874.5 units are held by the public (R. 518, 578, 582, 584)

these companies and the bondholders were offered securities of the debtors for their bonds in the subsidiary companies (R. 578–579, 681). While some exchanges were made, the outstanding bonds of the subsidiaries were not reduced in sufficient amounts to avoid eventual defaults and the consequent proceedings for the reorganization of the underlying companies as well as of Federal and National.

Kulp, his son, and Myrtle Johnson, were the original common-law trustees of the debtors. In 1933 they resigned following an investigation by the United States Department of Justice. At the time of his resignation, Kulp transferred to George Andresen, one of the successor common-law trustees, under a separate trust agreement, all his holdings in the top trusts and their subsidiaries for the benefit of those who had been previously induced to exchange bonds of the latter for securities of the trusts (R. 154, 517, 578). These securities were subsequently sold at a judicial sale referred to below.

Paul E. Darrow was appointed reorganization trustee of Federal and National in 1935, and, until his resignation on August 10, 1943, he conducted the business of the debtors and managed the 27 subsidiary building companies. As manager of the debtors and the underlying properties, Darrow engaged in the purchase of bonds of the subsidiary companies at a discount for retire-

ment (R. 513). During his administration, as the court below noted (R. 680–681; 184 F. 2d 1, 4–5), bonds of the subsidiaries were reduced from $7,611,700 to $5,197,100 face amount. Economy in the carrying out of this extensive purchase program was obviously of great importance to the estates (R. 553). When Darrow filed his final reports and accounts as former trustee of both Federal and National, the Securities and Exchange Commission, the successor trustee, and the indenture trustee of Federal's bonds filed objections. These were referred to a special master (R. 134–148), whose detailed findings of fact and conclusions, insofar as pertinent herein (R. 498–560), were adopted by the district court (R. 583–584).

Kulp and Miss Johnson were employed by Darrow, were paid regularly salaries out of the estates, and were placed in key positions in the reorganization. As found by the Special Master, Miss Johnson had supervision over the trustee's office, advised Darrow on all phases of management, and assisted him generally in the reorganization of the subsidiaries. She had charge of all records including complete data respecting the properties, income and expenditures of the debtors and their subsidiaries, and was the best informed person in the organization regarding the various enterprises. Darrow depended upon her ability and judgment and regularly consulted her

regarding purchases of the securities of the subsidiaries, the allocation of funds for sinking fund operations and prices to be offered (R. 189–191, 209–211, 339, 513, 579).[2] Kulp was retained to manage the physical properties for Darrow. He also had access to all records and information and enjoyed Darrow's absolute confidence (R. 182, 199–200, 512–513).

Kulp and Miss Johnson were retained by Darrow with the express understanding that they were to be permitted to trade in securities of the debtors' subsidiaries (R. 511). Although Darrow testified that he had discussed their employment with the court and with counsel and others, it is undisputed, as found by the Special Master, "that he did not specifically tell these persons that Miss Johnson and Kulp would be dealing in the securities of the subsidiaries" (R. 512). During their employment by Darrow, Kulp and Miss Johnson traded extensively in bonds of the debtors' subsidiaries and, indeed, on many occasions sold bonds directly to Darrow as trustee. Much of this trading was through Colonial Securities Corporation ("Colonial"), a corporation wholly owned by Kulp and Miss Johnson. For a substantial period of Darrow's trusteeship, Colonial

[2] With respect to all but seven or eight subsidiaries Darrow had sole authority to determine prices. In the case of the other subsidiaries, maximum prices were fixed by the boards of directors or special trust committees, but Darrow usually had discretion to raise or lower the prices within prescribed limits (R. 513).

shared office facilities and personnel with the debtors' estates and dealt largely in securities of the debtors and their subsidiaries (R. 168, 513, 538–540, 579). The profits realized by them on these transactions amount approximately to $43,000, of which $8,600 was derived from direct sales to Darrow. In many instances, when purchasing from Miss Johnson, Darrow paid for the securities in advance of delivery or prior to her own purchases (R. 208, 337–338, 520–521). Frequently, bonds purchased by Miss Johnson or Colonial were sold at a profit to Darrow on the same day, or within a few days after their purchase, and some of the bonds thus sold to Darrow had been purchased by Miss Johnson from bondholders who had come to the office to sell their bonds to the trust. Darrow made no inquiry as to the prices Miss Johnson or Colonial had paid for the securities; he asked for no accounting and made no check of Colonial's books, to which apparently he had access (R. 210–211, 341, 514–515, 538–539).

By far the largest single transaction involved the acquisition by Miss Johnson and her associates of the substantial block of securities which had been turned over by Kulp to the Andresen trust (p. 4, *supra*). These were acquired by Miss Johnson at a total cost of $24,000 (R. 518) at a judicial sale ordered by the Superior Court of Cook County, Illinois. These securities consisted of two lots, one involving $199,000 face

amount of bonds of subsidiaries, the other substantial amounts of the debtors' securities.[3]

About one-half of the purchase price was obtained by Miss Johnson through a resale to Darrow of $128,700 in face amount of bonds of the subsidiaries for $12,447, although the cost to Miss Johnson of all the securities in that lot was approximately $8,000 (R. 519–521). As was his custom (R. 519), Darrow paid for these securities in advance of delivery and, as the court below stated, "it is undisputed that the checks issued by Darrow to Colonial were used in making the payment due under the bid" (R. 683; 184 F. 2d 1, 6). Additional bonds of the subsidiaries were sold by Miss Johnson to customers of Colonial, who subsequently resold some of them to Darrow (R. 522). As a result, Miss Johnson realized a total of $34,905 on the securities of the subsidiaries, or $10,701 more than she had paid for both lots, and retained the debtors' securities at no net cost (R. 520–523, 556). The treatment of the latter securities, which may determine control over the reorganized debtors, is now pending before the District Court (R. 522, 557).[4] The surcharge of

[3] These securities were: $286,100 principal amount of Federal bonds; 62,358 units of beneficial interest of Federal, representing over 60 percent of the equity in Federal; and 10,761.6 units of National, representing about 25 percent of the equity in National (R. 518).

[4] In accordance with the recommendation of the Special Master, the District Court has reserved jurisdiction to permit consideration of an additional surcharge against Dar-

the trustee which the court below set aside, in so far as it relates to this purchase, includes only the profits realized on the resale of the securities of the subsidiaries.[5]

In his report (R. 498–560), filed on April 28, 1948, the Special Master concluded that on the basis of the evidence Darrow's acquiescence and active support of the trading activities of Kulp

row, depending upon the disposition of these securities (R. 556–557).

[5] Jurisdiction was also reserved for further surcharge based upon so-called "accounts receivable." These are discussed in detail in the Special Master's report (R. 534–538). Briefly, it appears that during the period in which Jacob Kulp & Co. managed the properties of the subsidiaries it commingled in its bank account its own funds and those of the subsidiaries. Loans were made from these commingled funds to the weaker subsidiaries and to the debtors, and these loans were recorded as "accounts receivable" due to Jacob Kulp & Co. Since the total bank balances of Jacob Kulp & Co. were generally substantially less than the amounts due the various subsidiaries, it was evident that the loans made by Jacob Kulp & Co. were made from funds belonging to the stronger subsidiaries. At the sale in 1936 of these accounts receivable in the bankruptcy proceeding of Jacob Kulp & Co., Miss Johnson purchased at a net cost of $400 these alleged receivables in the total face amount of $172,436. These purchases were made for Kulp's son-in-law, but she retained an interest therein for herself and Kulp. Although he knew the nature and origin of these accounts and the manner of their acquisition, Darrow acquiesced in their allowance in the reorganization affecting six subsidiaries. The Special Master concluded that Darrow's failure to oppose the claims was "deserving of censure" (R. 558), but recommended no surcharge or other form of redress at this time in view of the possibility that damage might be eliminated in the pending reorganization of National and Federal (R. 559), and the District Court agreed with this recommendation (R. 584).

and Miss Johnson at a time when "the trusts and their subsidiaries were attempting to retire their indebtedness as rapidly and as inexpensively as possible * * * was pregnant with potential conflicts of interest" (R. 553), and that for allowing his employees' "infidelity to inflict direct financial loss upon the trusts" Darrow was derelict in his duties as trustee (R. 554). The Special Master, accordingly, recommended that Darrow be surcharged in the amount of $43,000, representing the profits which these employees obtained as a result of their trading in securities of the debtors' subsidiaries. On consideration of the evidence and of the Special Master's report, the district court concluded that the evidence supported the findings and recommendations of the Special Master. On appeal by Darrow, the court below reversed the decision of the district court basically on the theory that, regardless of the profits made by Kulp and Miss Johnson, Darrow's purchases had been beneficial to the debtor (R. 675–692).

SUMMARY OF ARGUMENT

I

A preliminary contention is raised by the respondent to the effect that this Court is without jurisdiction on the ground that the petition was not filed by proper parties, since Stacy C. Mosser, in whose name the petition was filed, had resigned as cotrustee of both debtors prior to the filing

of the petition, and since, in respondent's view, the indenture trustee, who joined in the petition, has no standing to do so. In our view there is no merit to this contention. The position of a successor trustee is comparable to that of an assignee of an interest *pendente lite*. Since it is undisputed that this petition was actually, if not in name, filed by the present trustees, the motion for substitution is but a request for a formal correction of the record to indicate the present representatives of the debtors' estate whose interest is vitally affected by the order under review. Respondent's contention rests upon an irrelevant analogy to cases involving public officers. Also the indenture trustee has a statutory right to be heard in the proceeding which carries with it the right to seek review.

II

The court below did not disturb the ultimate facts as found by the Special Master and adopted by the District Court. The decision below appears to hold that a trustee who did not himself profit from the estate cannot be held accountable for knowingly permitting subordinates in responsible positions to engage in a course of conduct in conflict with the interest of the estate. In our view the statutory provisions and the judicial decisions, which emphasize the importance of a loyal and disinterested trustee in the management of a bankruptcy reorganization, would be vitiated if

the trustee were permitted to shut his eyes to activities of his subordinates in which he himself is forbidden to engage. Divided loyalties and conflicts of interest may produce the same type of harm when they prevail among the trustee's advisers as when the trustee himself is involved. The respondent's tolerance and active support of the trading activities of his subordinates constituted a flagrant abuse of his fiduciary responsibilities for the proper administration of the estates in reorganization.

In part, the decision below was based upon a lack of judicial precedent to support the surcharge. This overlooks the extensive powers of a bankruptcy court, as a court of equity, to adjust the remedy to meet the need. The surcharge in this case is essential to safeguard the administration of the bankruptcy reorganization and to compensate the estates for the immeasurable harm which the respondent's neglect of his fiduciary responsibilities produced.

ARGUMENT

I

THE SUBSTITUTION OF THE PRESENT TRUSTEES OF THE DEBTORS AS PETITIONERS IS PROPER

On January 25, 1951, Joseph Schwartz and Frank W. Whiston, the present trustees of Federal and National, respectively, filed a motion to be substituted as petitioners in lieu of Stacy C. Mosser, the nominal petitioner herein. This

Court has reserved action on the motion in order that it may be considered at the same time as the issues on the merits, and it is therefore before the Court at this time.

It will aid in the consideration of this problem to have the chronology of the events in mind:

August 13, 1943—Mosser became trustee of both Federal and National.

April 12, 1949—District Court issued order surcharging Darrow.

April 29, 1949—Darrow filed a notice of appeal from the district court order.

May 11, 1949—Guild, indenture trustee for Federal collateral trust bonds, filed a notice of appeal from the district court.

November 7, 1949—Schwartz became co-trustee of Federal and Whiston became co-trustee of National.

August 14, 1950—The court of appeals issued its order reversing the district court.

September 21, 1950—The court of appeals denied rehearing.

September 29, 1950—The court of appeals issued its mandate.

October 17, 1950—Mosser resigned as co-trustee of National.

October 26, 1950—The district court authorized Mosser and Schwartz, co-trustees for Federal, and Whiston, trustee for National, to file petitions for certiorari.

December 1, 1950—Mosser resigned as co-trustee of Federal.

December 18, 1950—Petitions for certiorari were filed in the name of Mosser as trustee for both debtors, and by Guild, the

indenture trustee for the Federal collateral trust bonds.

January 25, 1951—Schwartz, present trustee of Federal, and Whiston, present trustee of National, filed a motion to be substituted for Mosser, in whose name the petition had originally been filed.

We submit that the motion should be granted. The petition for certiorari was filed in the name of Mosser, who was the trustee of record in the court below, neither Schwartz nor Whiston having been made formal parties to the appeal and the mandate of the court having issued. It appears from the affidavit submitted in support of the motion for substitution, and this does not seem to be disputed, that the petition was filed "with the knowledge, consent and participation of Messrs. Schwartz and Whiston" and with the intention of subsequently applying to this Court for substitution. The proposed substitution involves no more than a formal correction of the record to designate the parties now responsible for continuing the litigation on behalf of the debtors' estates, and appears to be contemplated by Section 46 of the Bankruptcy Act, 52 Stat. 840, 860, 11 U. S. C. 74,[6] and to be in accord with the practice long followed in the courts.

[6] Section 46 of the Bankruptcy Act provides:

Death or Removal of Receivers or Trustees.—The death or removal of a receiver or trustee shall not abate any suit or proceeding which he is prosecuting or defending at the time of his death or removal, but the same may be proceeded with

1. The jurisdictional question raised by the respondent in opposition to the motion for substitution was answered by this Court in *Bowden* v. *Johnson,* 107 U. S. 251. That case involved a suit to enforce the statutory liability of a stockholder of an insolvent bank. The suit was brought by Bowden as receiver of the bank. In June 1878, Adams was appointed receiver of the bank in place of Bowden. The decree of the Circuit Court was entered in January, 1879, and an appeal to this Court was taken in the name of Bowden, who apparently was the party of record below. Adams filed a motion in this Court to be substituted as plaintiff and appellant. The appellees and their counsel, who had first heard of the appointment of Adams from the papers served on the motion for substitution, moved to dismiss the appeal, urging that no valid appeal was ever taken. This Court allowed the substitution; and since on the merits it was held that the receiver was entitled to judgment, the case was remanded to the court below "with directions to that court to enter a decree in favor of the substituted plaintiff, as receiver," 107 U. S. at 264.

The same principle was stated by this Court in *Gates* v. *Goodloe,* 101 U. S. 612, relied upon

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or defended by his joint receiver or joint trustee or successor in the same manner as though the same had been commenced or was being defended by such joint receiver or joint trustee alone or by such successor.

in the *Bowden* case *supra*. In that case a money judgment was obtained in the state court against three partners, and a judgment for a lesser amount was affirmed on appeal On August 1, 1876, two of the partners were discharged in bankruptcy and on October 30th of that year all three partners brought the case to this Court on a writ of error. The defendant in error moved for dismissal on the ground that only the assignee in bankruptcy could prosecute the writ on behalf of the discharged partners. This Court denied the motion, stating that even if it were assumed that the bankrupts could not bring a writ of error after their discharge, "all difficulty, in that respect, has been removed by the application of the assignee for an order here substituting him as a plaintiff in error," and that, with both the assignee and the third partner before the court, "there is no sound reason why the cause should not proceed to a final determination upon the errors assigned," 101 U. S. at 613, 614.

It thus appears that in effect receivers and trustees or their successors are regarded as comparable to transferees or assignees of an interest *pendente lite*. It is well settled that such assignment is no cause for abatement of the action, and "the assignee may, at his own election, come in by an appropriate application, and make himself a party, so as to assume the burden of the litigation in his own name, or he may act in the name of his assignor," *Ex parte Railroad Co.*,

95 U. S. 221, 226. See also *F. A. Mfg. Co.* v. *Hayden & Clemons, Inc.*, 273 Fed. 374, 378–379 (C. A. 1). The substance of this rule is now reflected in Rule 25 (c)[7] of the Federal Rules of Civil Procedure. Substitution is also proper in the appellate court even though the transfer of interest occurred prior to the appeal.[8] Likewise, in *Bragg* v. *Gerstel*, 148 F. 2d 757 (C. A. 5), involving a bankruptcy proceeding, the court of appeals permitted the substitution of an assignee of a creditor's claim, and rejected the contention that the appeal was void because not taken by the real party in interest. The court stated that, "We do not think the appeal thus taken by an authorized attorney in the name of the original creditor was void. Gillett, the present owner, is properly to be substituted in the record as the true litigant on his motion, thereby assuming directly the costs to which he may become liable." 148 F. 2d at 759.

The assimilation of receivers, trustees, or their successors to the status of assignees *pendente lite*, suggested by this Court's decisions in the *Bowden* and *Gates* cases, *supra*, was indicated explicitly

[7] Rule 25 (c) provides: "Transfer of Interest.—In cases of any transfer of interest, the action may be continued by or against the original party, unless the court upon motion directs the person to whom the interest is transferred to be substituted in the action or joined with the original party." See also New York Civil Practice Act § 83 (1946); Deering's California Code of Civil Procedure § 385 (1949).

[8] *Sumpter Lumber Co.* v. *Sound Timber Co.*, 257 Fed. 408, 410 (C. A. 9).

in *Myers* v. *Canton Nat. Bank of Canton, Ill.*, 109 F. 2d 31 (C. A. 7). That case involved a suit for a money judgment against a bank which was in receivership. The complaint was dismissed by the District Court because of failure to state a cause of action and the plaintiff appealed, naming the bank and the receiver as appellees. The appellees moved to dismiss the appeal on the ground that prior to the appeal a new receiver had been appointed and that consequently the appeal must be dismissed because an indispensable party, the new receiver, had not been made a party to the appeal. Although noting that neither party had previously called the attention of the court to the change in receivers, and while apparently no formal substitution was requested, the court overruled that motion, expressly citing Rule 25 (c) of the Federal Rules of Civil Procedure which it held applicable to appellate proceedings before it. Rule 25 (c) provides for the continuation of litigation after a transfer of interest. The court further stated that it was unnecessary to decide whether the new receiver was merely a proper or in fact an indispensable party, and added: "If the new receiver wishes to be substituted as a party and will apply for leave to be made a party, his request will be granted." 109 F. 2d at 34.[9]

[9] Additional support for the views urged herein is derived from the cases dealing with the procedural effects of bankruptcy upon pending actions by or against the debtor. In such circumstances, the action does not abate by reason of

In the circumstances of this case, the substitution of the co-trustee or successor reorganization trustee is likewise proper. There is no dispute here over the authority of the present trustees to file the petition. The original orders dated November 7, 1949, appointing Whiston and Schwartz as cotrustees of National and Federal respectively and entered during the pendency of the appeal below, expressly authorized the cotrustees to institute or maintain suits for the recovery and protection of the property of the debtors and specifically authorized such trustees "to continue to defend any pending actions or suits in which the debtor or the trustees may have an interest as plaintiff, defendant or otherwise."[10] It is like-

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the debtor's bankruptcy. *Thatcher* v. *Rockwell*, 105 U. S. 467, 469–470; *Paradise* v. *Vogtlandische Maschinen-Fabrik*, 99 F. 2d 53, 55 (C. A. 3). At his election the trustee, although vested with legal title to the debtor's causes of action, may intervene or be substituted as a party; or he may let the suit continue and be bound by the judgment. See *Eyster* v. *Gaff*, 91 U. S. 521, 523–524. See also *Kaplan* v. *Joseph*, 125 F. 2d 602, 607 (C. A. 7). The same rules apply to derivative stockholders' action where bankruptcy of the corporation intervenes. See *Meyer* v. *Fleming*, 327 U. S. 161, 167–168.

[10] These orders set out in the appendix to the motion for substitution authorized the co-trustees of both debtors (pp. 22, 26):

"h. to institute, prosecute, and maintain suits or proceedings at law, in equity, or under statute, in any court of competent jurisdiction, for the recovery, protection, or maintenance of the property, assets, and business of the debtor or of the trustees; and

"i. to continue to defend any pending actions or suits in which the debtor or the trustees may have any interest as plaintiff, defendant, or otherwise."

wise undisputed that the District Court, by its order of October 26, 1950, specifically authorized the present trustees to file the petition herein. (Motion for Substitution pp. 29–30.) Accordingly, and especially in view of Section 46 of the Bankruptcy Act (p. 14, *supra*), the fact that the petition was filed by the present trustees in the name of their predecessors is at most a formal or harmless defect which, as in the *Bowden* case, the motion for substitution will correct. It is inconceivable that such formalities may be invoked to defeat the review by this Court of a controversy which is of vital interest to the estates and their security holders.

The decision of this Court in *Snyder* v. *Buck*, 340 U. S. 15, referred to by the respondent, is not relevant. That case dealt with the substitution of a public officer as a party, and the procedural problem there involved arose as a result of the unique and historic principle "that in absence of a statute an action aimed at or compelling an official to discharge his official duties abated where the official died or retired from the office," 340 U. S. at 18. All that it holds is that strict compliance with the statutory provisions for substituting the successor public officer is essential in order to avoid abatement. In *United States* v. *Boutwell*, 17 Wall. 604, 609, substitution of a successor public officer was not permitted in this Court because, in the absence of statutory authority, it would amount to "the exercise of original jurisdiction over both a new party and a

new cause." The cases discussed and cited above demonstrate that such conceptions are wholly inapposite to successor receivers or trustees.

Davis v. *Preston,* 280 U. S. 406, referred to by the respondent, also stems from the anomalous rule as to abatement of causes involving public officers. Since historically the public officer was not considered an assignee or transferee of his predecessor's interest, substitution, as the *Boutwell* case implies, is but a device for permitting a successor public officer, a "new party", to replace a predecessor and thereby obviate the necessity of an action *de novo.* Viewed against this historic background, all that the *Davis* case holds is that the statutory authority for substitution did not enlarge the appellate jurisdiction of this Court so as to extend the time for the filing by the new party of a petition for a writ of certiorari. See *Snyder* v. *Buck,* 340 U. S. at 21. In bankruptcy, however, the resignation of the trustee or the receiver is no cause for abatement; and even in the absence of a specific statute, this Court permitted in the *Bowden* case, *supra,* the substitution of a successor receiver and, in remanding the case, directed that judgment be entered in favor of the substituted receiver. From the standpoint of abatement and substitution, as we have noted above, the trustee or his successor is like an assignee of a cause of action during the pendency of the litigation, and the substitution procedure is merely an amendment of the record to designate the present rep-

resentative of the estate which is the real party in interest.

It is significant that the *Bowden* case was decided in 1882, or 17 years before the Act of February 8, 1899 (30 Stat. 822), which was passed by the Congress at the suggestion of this Court in *United States ex rel. Bernardin* v. *Butterworth,* 169 U. S. 600, 605, to permit substitution of public officers.[11] In permitting the substitution in the *Bowden* case this Court in effect treated the substitution as merely an amendment of the record and stated (107 U. S. at 264) that "the power of amendment to this extent is authorized by section 954 of the Revised Statutes." This section of the Revised Statutes, formerly 28 U. S. C. 777, dealt with amendments pertaining to defects of form and provided that such defects shall not be a cause for abatement and that in its discretion the court "may at any time permit either of the parties to amend any defect in the process or pleadings."[12] We submit

[11] Of course, the abatement rule with respect to public officers was settled law long before the decision in the *Bowden* case. See *Secretary* v. *McGarrahan*, 9 Wall. 298, 313; *United States* v. *Boutwell*, 17 Wall. 604, 607–608.

[12] The Act of June 25, 1948, which revised Title 28, repealed former 28 U. S. C. 777 (62 Stat. 993). Amendments permitted thereunder are now governed by Rules 15 and 61 of the Federal Rules of Civil Procedure. Rule 15 gives the court wide discretionary powers to permit amendment of pleadings and Rule 61 relating to harmless error specifically provides for disregarding "any error or defect in the proceeding which does not affect the substantial rights of the parties."

that the same latitude should be applied to the substitution of a successor reorganization trustee, and the unique development in the law pertaining to the substitution of public officers ought not to be extended to areas where it has not been previously applied.[13]

2. Wholly apart from the status of the petition filed in the name of Mosser, one of the petitioners herein is the indenture trustee for Federal's collateral trust bonds, so that there is a proper petition for reviewing the order below insofar as it affects Federal. There is no merit in respondent's challenge of the indenture trustee's standing to file a petition. Section 206 of Chapter X (11 U. S. C. 606) expressly provides that "the debtor, *the indenture trustees,* and any creditor or stockholder of the debtor shall have the right to be heard *on all matters arising in a proceeding* under this chapter." [Italics added.] This section has been construed to give these parties the absolute right to be heard in all matters arising in the proceeding which may affect their interest, and this right carries with it the right to appeal.[14]

[13] Compare cases which except from the abatement rule a suit to enforce an obligation of a corporation or of a municipality to which the office was attached. See *Murphy* v. *Utter*, 186 U. S. 95, 101–102. This exception was also noted in *Snyder* v. *Buck*, 340 U. S. 15, 18, note 3.

[14] See *Young* v. *Higbee Co.*, 324 U. S. 204, 210–213; *Matter of Keystone Realty Holding Co.*, 117 F. 2d 1003, 1005 (C. A. 3); *Dana* v. *S. E. C.*, 125 F. 2d 542, 543 (C. A. 2); see also *In re South State Street Bldg. Corp.*, 140 F. 2d 363, 367 (C. A. 7), certiorari denied, 322 U. S. 761.

In this case the indenture trustee participated in the proceedings in the district court and in the court below (R. 499, 568–569, 582, 585–586, 697) and the decision below clearly affects the interest of Federal's bondholders on whose behalf the indenture trustee has a statutory right to be heard and with it the right to seek review.

The respondent argues that Federal is solvent and hence, even though an indenture trustee generally may have the right to seek review, he cannot do so in the circumstances of this case since the bondholders' interest is not affected by the order of the court below. The question of solvency is a factual matter as to which the record is barren. There is nothing in this record to indicate the extent or the degree of the debtor's solvency and, since no plan of reorganization has yet been formulated, the impact of the order below upon the rights of creditors is not readily ascertainable at this time. At the very least, the order of surcharge, which the court below reversed, does affect the cushion or margin of safety for Federal's collateral trust bonds. Accordingly, it cannot be said as a matter of law that the interests of the public bondholders of Federal are unaffected by the order sought to be reviewed.

In his appeal below the respondent had made the indenture trustee a party appellee (R. 585–586, 591). He ought not be heard for the first time to object to the indenture trustee's statutory right to seek review of an order which, even on the limited facts presented by this record, would

appear to be of substantial consequence to the public bondholders of Federal.

II

IT WAS PROPER TO SURCHARGE THE BANKRUPTCY TRUSTEE FOR PROFITS REALIZED, WITH HIS KNOWLEDGE AND ASSISTANCE, BY HIS SUBORDINATES FROM TRADING IN SECURITIES OF THE DEBTORS' SUBSIDIARIES

On the appeal below, the respondent did not challenge the ultimate findings of fact as determined by the Special Master and affirmed by the District Court. The court below stated: "There is little, if any, controversy as to the facts pertinent to the problems presented in these appeals" (R. 678; 184 F. 2d 1, 3). Nor did the respondent in terms attempt to vindicate the trading activities of Kulp and Miss Johnson, or to deny his acquiescence therein. Rather, he contended that he could not be surcharged "for a wrongdoing of his employees" under the circumstances of this case; that Kulp and Miss Johnson were only "part-time" employees; and that they were "competent" employees whose services, he argued, he could not have secured "unless he permitted them to continue their established business (Colonial Securities Company) and further permitted them to deal in the underlying securities of the two bankrupt trusts." (Br. pp. 27, 28.) He also argued that the estates had suffered no actual loss from the trading activities he permitted, and on the whole had benefited from his administration.

Without disturbing the ultimate findings of fact, the court below reversed the order of

surcharge, holding that the respondent could not be held accountable for the trading of his subordinates because it considered that his purchases had benefited the estates and that the surcharge was without precedent.

1. Although under the Bankruptcy Act the reorganization trustee is not prohibited from employing officers affiliated with the estate, it is undeniable that in retaining their services the trustee may not enter into any arrangement in conflict with his fiduciary responsibility for the proper and effective administration of the reorganization. Nor is the trustee thereby relieved "of the duty of exercising care and prudence within the field left to his discretion." *United States ex rel. Willoughby* v. *Howard,* 302 U. S. 445, 452. The retention of Miss Johnson and Kulp, whatever their competence, upon condition that they be permitted to trade in the securities of the debtors and their subsidiaries was in itself inconsistent with the elementary dictates of common prudence. Since one of Darrow's important undertakings as trustee was to purchase bonds of the subsidiaries, the employment of Kulp and Miss Johnson under the circumstances gave them, in addition to their regular remuneration, continuous opportunities for profitir , to the detriment of the estate on the basis of inside information, and necessarily led to divided loyalties and continuous conflicts of interests in the day-to-day administration of the reorganization proceedings. Darrow's tolerance and active support of

the trading activities of Kulp and Miss Johnson, coupled with his complete failure to exercise an independent scrutiny of these activities, constitute an abdication of his supervisory duties with respect to his subordinates and a flagrant abuse of his responsibilities for the proper administration of the estates in reorganization. The Special Master and the district court held him derelict in both respects (R. 553–4, 584).

The potential dangers to the estate from the arrangements made for the retention of Kulp and Miss Johnson should have been obvious to Darrow at the outset. At the very least, he should have sought the advice of the court before embarking on so dubious and hazardous a course. Although he claimed that he had informed the court of their employment, it is clear, as already noted, that he did not specifically disclose "that Miss Johnson and Kulp would be dealing in the securities of the subsidiaries" (R. 512). Certainly, it was Darrow's responsibility to dispense with their services, as he undoubtedly had the power to do, when the consequences of their divided loyalties and conflicting interests became more patent. Darrow, however, not only failed to take the necessary action but knowingly permitted their trafficking in securities to continue without restraint and aided their trading by allowing them to profit on sales to him and by making payments in advance of delivery. Without providing any semblance of justification he

has maintained that whether or not his subordinates traded in securities and profited by selling to him or in the market generally, the amount of their profit were none of his concern (R. 211, 341, 514). Having deliberately disregarded his obvious responsibility for supervising their activities, he cannot escape accounting for the foreseeable and, indeed, inevitable consequences of his willful neglect. *Cf. Meinhard* v. *Salmon*, 249 N. Y. 458, 164 N. E. 545 (1928).

The circumstances that Darrow himself did not personally profit by the trading of his subordinates and that Kulp and Miss Johnson may have been "part-time" employees—and this apparently is emphasized by the court below (R. 685-686; 184 F. 2d 1, 4, 7)—is beside the point. It is axiomatic that the standards of fiduciary responsibility, which exclude divided loyalties and conflicts of interests with respect to the trustee, necessarily impose upon him an affirmative obligation not to tolerate—much less actively support—the same vices in his subordinates. Divided loyalties and conflicts of interests tend to produce the same harm when they prevail among employees, upon whose skill and knowledge the trustee relies for the proper discharge of his own fiduciary responsibility, as when the trustee himself is involved. There can be no doubt that in deliberately condoning and actively supporting a course of dealing by his subordinates

which was obviously against the interests of the estate, Darrow was guilty of misconduct.

The record certainly does not support any characterization of the employment of Kulp and Miss Johnson as "part time" in the sense that their connection with the administration of the estate was casual or that the consequences of their freedom to trade in securities of the debtor and its subsidiaries was insignificant. As to their duties as employees of the trustee, Miss Johnson particularly was in a sensitive position. She advised the trustee on his purchase program and apparently handled for him negotiations leading to the acquisition of securities. She had a wide acquaintance among the security holders and knew more about the financial affairs of the estates than any other person (R. 512).[15] The important question was not whether she was a "part time" or a full-time employee, but whether her private and official activities conflicted. There can be do doubt that they did. Insofar as Kulp and Miss Johnson were in fact "part

[15] Kulp and Miss Johnson were no mere outsiders retained by Darrow to assist him in routine matters of administration. They had been the promoters and organizers of the underlying building companies and of the debtors, and through Jacob Kulp & Co., which they controlled, they had underwritten and distributed by public sale almost all the underlying bonds of the subsidiary companies. The entire equity of the 27 building companies originally had been held by Kulp and his family, and Jacob Kulp & Co. had managed the various properties pending the reorganizations (R. 152, 262, 578, 679).

time" employees of the trustee, it was because they utilized the remainder of their time in the very trading activities condemned by the Special Master and the district court.[16] In this sense, any faithless employee is a "part time" employee.

2. The decision of the court below emphasizes that Darrow's program of purchasing securities of the subsidiaries was beneficial to the estate, and that he purchased the securities from Miss Johnson of Colonial at prevailing "market" prices (R. 681, 683, 184 F. 2d 1, 5, 6). We believe it is irrelevant that in view of the general price rise for real estate and real estate securities, the estates have benefited from Darrow's purchases. The surcharge would compensate the estates for additional benefits they might have received had Darrow acted properly. Aside from the question of Colonial's influence on the "market",[17] Miss Johnson's advice to Darrow

[16] The record also shows that during the time of Darrow's appointment Colonial's business was almost entirely concerned with the securities of the debtors and their subsidiaries (R. 155, 160–1, 168, 207). It served merely as the corporate medium for trading by Johnson and Kulp in the underlying securities and their employment by Darrow, far from interfering with the operation of Colonial, provided them, as we have noted, with additional advantages to aid their trading activities.

[17] Miss Johnson testified: "Colonial was the trading house for all the securities since no one knew Darrow or Federal" (R. 188). Darrow's accountant testified: "I would not say that Colonial maintained a market for the securities of the subsidiaries but they assisted in maintaining a market. The trusts and the individual companies maintained the market . . . While Colonial was active, brokers contacted it

with respect to the timing of, and prices for, his purchases necessarily was in conflict with her own interest as a trader in the over-the-counter market.[18] Systematic trading by Miss Johnson and Kulp, directly or through Colonial, was bound to interfere with Darrow's opportunities to make the favorable purchases which Miss Johnson or Colonial appropriated for their own account. The Special Master found (R. 514):

> Thus, when bondholders came into the office desiring to sell bonds, Miss Johnson knew what price Darrow was paying and purchased at a price below that figure. She told the security holders that they were getting the "market price" for their bonds and purchased on her own behalf or on behalf of Colonial. The bonds so purchased were subsequently resold to Darrow. In almost every case Miss Johnson or Colonial made a profit. (SEC Exs. 5 and 6.) Occasionally Colonial sold bonds

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regarding the purchase and sale of bonds. As a result of those contacts, bonds were sold to Darrow and this represents a substantial portion of the bonds he bought. Brokers who wanted to sell bonds would contact Colonial, find out the price, and then the bonds would be sold to Darrow. Apparently, Colonial was the source of market information or clearing house for the bonds of the subsidiaries" (R. 155, 160–161).

[18] According to Darrow's own testimony (R. 211), when bonds did not come in fast enough, he frequently discussed with Miss Johnson whether the price was too low, and after a new price was established, anybody who offered bonds, including Johnson and Colonial, could get that price. That price would continue in effect until Miss Johnson and he got together and changed it.

at cost or less, but Miss Johnson testified that she, personally, always sold at a profit. Darrow's common practice to pay Miss Johnson or Colonial in advance of delivery tended to accentuate this conflict of interest. The acquisition of the securities in the Andresen trust sold at the judicial sale, described above (pp. 7–9, *supra*), provides a graphic illustration in point.[19]

The benefits which Darrow's purchase program had secured for the estates cannot be used as an "offset" against the substantial detriments which, as we have indicated, his neglect of duty had brought about. As reorganization trustee, it was his obligation to exert his skill and efforts at all times exclusively for the benefit of the estates and to administer his trust properly and effectively. Manifestly, it was on the assumption that his services were in keeping with this responsibility that allowances had been granted to him in the course of the reorganization.[20] Since he was re-

[19] The importance of Darrow's financial assistance in connection with his subordinates' purchases is underlined by his position that their limited financial resources justified abandonment of a claim by the estate against them despite advice of counsel that there was about an even chance of making a recovery (R. 530–534).

[20] The record shows that to date the respondent has received allowances in the amount of about $58,000 (R. 11, 39). The district court sustained objections to the granting of any further allowances to the respondent, reserving jurisdiction "to make such further orders respecting . . . the allowance or disallowance of compensation as requested by former Trustee Darrow, as equity may require" (R. 584–585).

miss in his duties with respect to his subordinates, he cannot avoid accountability simply because in some other respects he had discharged his obligations properly.

3. Insofar as the court's holding is based on lack of precedent for surcharging the trustee for the profits realized by his employees, it ignores the extensive powers of a bankruptcy court over the conduct of fiduciaries. As this Court has pointed out in *American United Mutual Life Ins. Co.* v. *City of Avon Park,* 311 U. S. 138, 146:

> Where * * * investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside few, or of one class of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need. * * * That power is ample for the exigencies of varying situations. It is not dependent on express statutory provisions. It inheres in the jurisdiction of a court of bankruptcy.

In enforcing this standard of fiduciary responsibility, the bankruptcy courts have applied a variety of appropriate sanctions.[21] On the un-

[21] See, for example, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, subordination of parent's claims against subsidiary; *Woods* v. *City National Bank and Trust Co.*, 312 U. S. 262, denial of compensation; *Young* v. *Higbee Co.*, 324 U. S. 204, accounting for profits; *In re Norcor Mfg. Co.*, 109 F. 2d 407 (C. A. 7), limitations of claims to cost; *In re Realty Associates Securities Corp.*, 56 F. Supp. 1008 (E. D. N. Y.),

disputed facts of this case, surcharging the trustee for profits made by his advisers is entirely appropriate. In large measure the correlation between damage to the estates and the surcharge is derived from the fact that these profits flowed from the trading advantages which Miss Johnson and Kulp secured through information and opportunities afforded them as "insiders", and represent benefits which a trustee mindful of his fiduciary responsibility might have secured for the estates.

The surcharge in this case may not reflect a precise equivalence between the overall profits obtained by Darrow's subordinates and any mathematically ascertainable losses incurred by the estates. Nevertheless the Special Master's report, adopted by the District Court, did rest upon the conclusion that Darrow "allowed their infidelity to inflict direct financial loss upon the trusts in many instances" (R. 554).[22] The bankruptcy

disqualification from serving on a committee; *In re Schroeder Hotel Co.*, 86 F. 2d 491 (C. A. 7), enjoining communications with security holders.

[22] That the basis for the surcharge was to protect the estate from certain, although indeterminable, harm is further emphasized by the treatment of the insurance brokerage commissions in the amount of over $16,000 which Kulp was permitted to realize in placing insurance on properties of director's subsidiaries. Although this arrangement was criticized it was found that the estate did not suffer since the rates were standardized and Kulp's familiarity of the properties was useful in reducing fire hazards and thereby effecting reductions in premiums. Accordingly, no surcharge was recommended with respect to these commissions (P. 526–527, 557–558).

court is not required to measure the precise extent of injury to the estates by determining which aspect of the reorganization has been corrupted by the activities of the trustee's subordinates and which has not. Administratively, such a task is not feasible since "the incidence of a particular conflict of interest can seldom be measured with any degree of certainty." *Woods* v. *City National Bank and Trust Co.*, 312 U. S. 262, 268. *Cf. Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 323. Such is particularly the case where, as here, the manifestations of conflicting interests were not occasional but persisted over a period of years in the day-to-day administration of the estates. In view of these circumstances, the remedy of the surcharge is but an application of the ancient principle "that the wrongdoer shall bear the risk of the uncertainty which his own wrong has created," *Bigelow* v. *RKO Pictures, Inc.*, 327 U. S. 251, 265. To insist upon a more precise measure by which the consequences of the respondent's wilful wrongdoing are to be determined is to encourage, rather than to deter, misconduct. As this Court said in the *Bigelow* case, "Any other rule would enable the wrongdoer to profit by his wrongdoing at the expense of his victim. It would be an inducement to make wrongdoing so effective and complete in every case as to preclude any recovery, by rendering the measure of damages uncertain. Failure to apply it would mean that the more grievous the wrong

done, the less likelihood there would be of a recovery." 327 U. S. at 264–265. See also *Story Parchment Co.* v. *Paterson Parchment Paper Co.*, 282 U. S. 555, 563.

There is a further consideration which we believe supports the District Court in resolving against Darrow any uncertainties as to the extent of the damage flowing from his maladministration. The record shows that during eight years of administration from 1935 to 1943, Darrow filed but one interim account of National and no account for Federal (R. 546). The district court remarked, "little or no explanation was offered the Master for the Trustee's woeful neglect of such a fundamental duty" (R. 583). The court below agreed with that conclusion (R. 690; 184 F. 2d 1, 10). The district court observed that Darrow's "failure to file reports rendered the determination of his reports and accounts not only extremely difficult but it necessitated conducting a great many hearings extending over a period of several years" (R. 583). It was in the extensive hearings on his final accounts that the facts were brought into full light.[23] Thus, Darrow's

[23] On June 19, 1942, the district court specially appointed one Frederick B. Andrews, a certified public accountant, to make an investigation of the trading transactions of Federal and National and its subsidiaries (R. 579). On August 13, 1943, Darrow resigned as trustee of Federal and National following a preliminary inquiry by this Commission and the submission of the Andrews Report to the court (R. 547–548, 580).

failure to file periodic reports, as required by law, to a large degree delayed inquiry into his administration, and prevented an earlier termination of an employment arrangement which produced the substantial damage to the estates.

4. The cases relied upon by the court below (R. 686–689; 184 F. 2d 1, 7–9) do not in our view support its decision, but merely stand for the general proposition, which we concede, that a trustee is only required to exercise reasonable care and prudence in the administration of his trust and that he is not subject to surcharge for the wrongful conduct of his employees where such misconduct has occurred without the trustee's fault or neglect and through no lack of proper supervision. However, it is equally well settled that a trustee must be surcharged for injury resulting from his negligence in supervising his employees. See *Carson, Pirie, Scott & Co.* v. *Turner*, 61 F. 2d 693 (C. A. 6); *In re Curtis*, 76 F. 2d 751 (C. A. 2). *A fortiori* the remedy of surcharge is essential where the loss or injury to the estate results from the trustee's deliberate failure to supervise the activities of his subordinates and from his active support of their improper activities.

5. In the court below the respondent argued that, even if a surcharge were proper in this case, it should be reduced by the expenses incurred by Colonial in realizing the profits on its trading transactions, such as commissions paid

to salesmen, office rent, clerical help, telephone charges, and the like.

This argument was presented to the Court of Appeals as an afterthought. In the course of the extensive hearings before the Special Master no clear proof was offered on behalf of the respondent with respect to the amount of these claimed expenses, and since this matter was not specifically raised before the District Court (R. 565–567), the respondent is precluded from raising it for the first time on review.[24] Nor, in our view, is there any merit to this contention. Had Darrow himself conducted the securities business and traded in the securities related to the debtors, he clearly could not have been permitted to offset such items against the profits for which he would be required to account. See *Young* v. *Potts*, 161 F. 2d 597, 600 (C. A. 6); *cf. Magruder* v. *Drury*, 235 U. S. 106, 118–120. There is no basis for applying a different rule where he is surcharged for the trading transactions of his subordinates. Since these profits represented the fruits of the trading advantages which Miss Johnson and Kulp secured as insiders, and represented in a large measure benefits which otherwise might have redounded to the estates, the fact that Kulp and Miss Johnson had to incur expenses through Colonial to avail themselves of these

[24] *In re Waern Building Corp.*, 145 F. 2d 584, 586 (C. A. 7) certiorari denied, 324 U. S. 871; *In re Grosse*, 24 F. 2d 305, 306 (C. A. 7).

profit-making opportunities neither mitigates the injury to the estates for which Darrow was responsible, nor lessens the measure of his accountability. Since, by its very nature, the extent of injury to the estates is not susceptible of precise measurement, the amount of surcharge as determined by the district court represents an appropriate measure of Darrow's liability.

CONCLUSION

For the reasons set forth above, the judgment of the court below should be reversed and that of the District Court should be affirmed.

Respectfully submitted.

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